Trade Policy During the Transition: Lessons from the 1990s

Paul Hare

1. INTRODUCTION

FROM the earliest days of the transition to a market economy in Central and Eastern Europe and the former Soviet Union it was understood that trade liberalisation and trade re-orientation would and should form central components of countries' economic policies, along with macroeconomic stabilisation, price liberalisation, privatisation and enterprise restructuring, and institutional reforms (Portes, 1991; EBRD, various years; and World Bank, 1996). What was less clear was how rapidly trade liberalisation should be pursued, whether imports or exports should be liberalised first, and what linkages there might be between the exchange rate, policy on capital account transactions, and foreign direct investment. Further, economists were unsure what a new, equilibrium trade structure would look like for the transition economies, or how rapidly such a new structure might be approached, though there was some early analysis of this issue using gravity models (Hamilton and Winters, 1992), or models based on historical trade patterns (Collins and Rodrik, 1991). Also, different countries or groups of countries from among the transition economies formed different types of trade alliance, with each other, with the EU, and so on.

With a decade of transition experience behind us, enough has been learned about trade policy in the transition economies to justify a review of the region's experience in order to elicit key lessons. Accordingly, this paper proceeds as follows. Section 2 reviews the trade policies pursued by transition economies during the 1990s, looking separately at trade in goods and services, foreign exchange market liberalisation and the exchange rate, and foreign direct investment. Section 3 then presents a brief statistical overview of what actually happened in the region in regard to the direction, composition and scale of trade.

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This section also outlines theoretical approaches to projecting trade flows, considers how far the region has moved towards a new equilibrium configuration of trade, and examines issues of competitiveness. Based on the previous two sections, the concluding Section 4 sketches what ideal trade policies might look like under a variety of transition conditions and draws out relevant lessons from the 1990s experience of trade policy.

2. TRADE POLICY DURING THE 1990s

At the start of transition, most of the formerly socialist economies dismantled the bulk of the export and import controls and licensing arrangements that were in place under the old central planning system (with the exception of some state-trading arrangements in Russia and elsewhere in the CIS; see Michalopoulos and Drebentsov, 1997); reduced the dispersion of tariff rates applied to imports and lowered their (trade weighted) average level; rationalised and unified their exchange rates; and introduced more accommodating policies towards foreign direct investment. In addition, 1991 saw the collapse of the CMEA, with the result that virtually all trade for the countries concerned, even that with former socialist partners, was conducted in world market prices, with settlement in convertible currencies. With the dissolution of the Soviet Union in late 1991, giving rise to 15 successor states (the three Baltic States plus the 12 members of the Commonwealth of Independent States, or CIS), established trade links across the region were also seriously disrupted. By 1993, initial steps to maintain a rouble currency zone across the CIS had given way to separate currencies for each country, and a diverse set of trading arrangements.

With such extensive trade liberalisation taking place across much of the region, albeit much less consistently and far reaching across the CIS (see Michalopoulos, 1999), one might wonder what remaining trade barriers there could be, aside from the tariffs still in force. However, there are some important barriers that must be noted here, though detailed discussion falls well outside the scope of this paper. These barriers are largely institutional to do with the inadequacy of banking systems, especially in handling international transactions reliably and at reasonable cost, the lack of export credit guarantee schemes and other forms of trade promotion (see MacBean, 2000), poor insurance and other business-related services. It is also often asserted that inadequate physical infrastructure – roads, railways, and the like – inhibits trade, though solid evidence for this is lacking. More often, the real barrier to trade is again institutional, taking the form of unreasonable customs delays at many borders in the transition economy region, accompanied by widespread demands for bribes to expedite the movement of goods (Beilock, 2000). This has nothing to do with economic policy *per se*, but is more a matter of the ability and willingness of the states concerned to enforce their own rules and to demand honesty from their officials.

a. Trade in Goods and Services

(i) Policies of the transition economies

(a) Central and Eastern Europe: Association Agreements and progress towards EU membership: Although a few Central European countries saw the collapse of communism as marking a ‘return to Europe’, and took it for granted that membership of the European Union would ensue quite rapidly, euphoria was soon overtaken by the harsh realities of their new situation. The EU was not ready to grant quick membership, but it moved rapidly to support the transition process and prepare countries for eventual accession. Its main instrument of support was the PHARE programme, providing a mixture of technical assistance for many areas of institutional reform (including aspects of trade policy and trade promotion), and some project financing (initially, however, PHARE funds could not be used for investment). Starting with aid for Hungary and Poland, the first two countries to end communist rule, the PHARE programme was eventually extended to 13 countries: Estonia, Latvia, Lithuania, Poland, the Czech Republic, Slovakia, Hungary, Bulgaria, Romania, Slovenia, Albania, Bosnia and Herzegovina, and the former Yugoslav Republic of Macedonia (FYROM). By the mid-1990s, the first 10 of these had signed Association Agreements with the EU, the so-called Europe Agreements.

These Agreements provided for co-operation between the EU and the Associated States in various fields, including legal approximation, political dialogue and advice on democratisation, environmental, transport and customs policies, institution-building to support market-type economies. However, the core of the Agreements concerned trade policy. Under each Agreement, the EU and the corresponding Associated State agreed to lift remaining trade controls against each other, including removing the tariffs that were still in place following the initial round of trade liberalisation. The EU was to liberalise sooner than the Associated State (this was the so-called ‘asymmetry’ in the Agreements) but for both sides the process was to be completed within five years from the coming into effect of the relevant Agreement. In practice, though, implementation of these provisions mostly occurred more swiftly than originally envisaged. Overall, a surprisingly liberal trade regime is now in place in the Central and Eastern European countries seeking EU accession, with Kaminski (1999) expressing some surprise that tariff reductions have not been offset by compensating non-tariff barriers to any great extent.

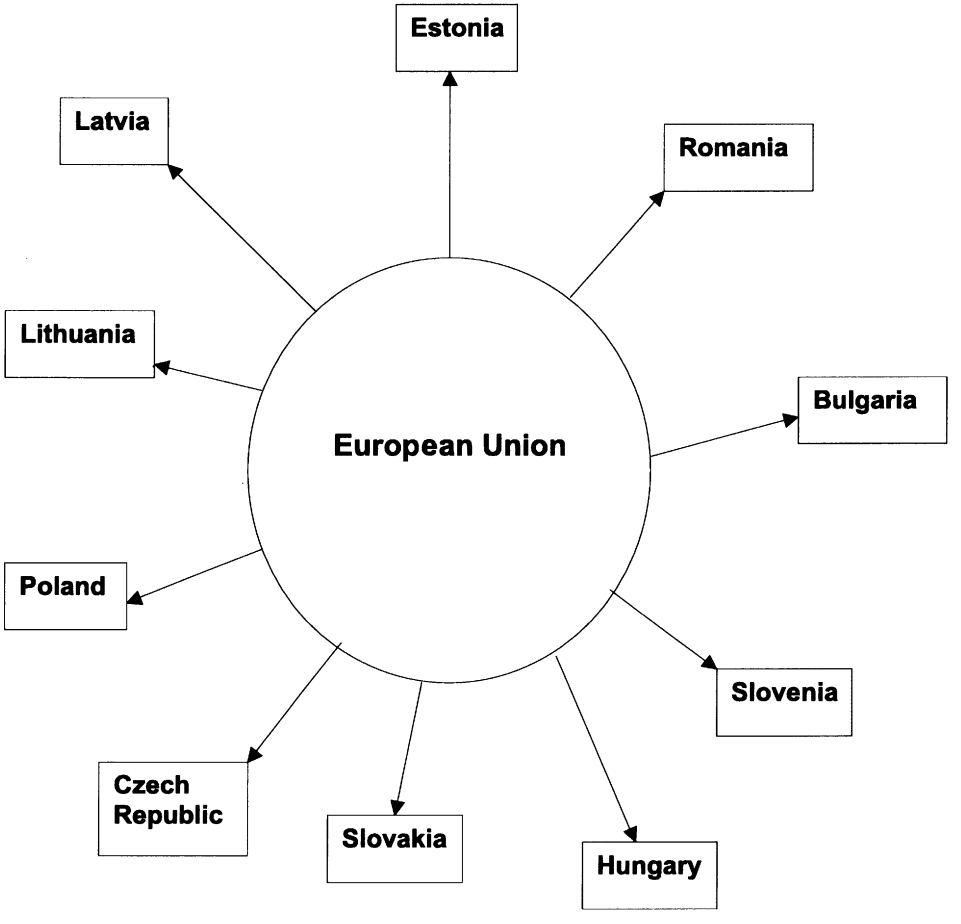
While this mutual liberalisation covered trade across a wide range of sectors, there were some important exceptions to do with products designated as 'sensitive'. These included agriculture, food products, iron and steel production, textiles and a few others that varied from country to country. Sensitive products, therefore, are those for which there are support regimes already in place within the EU, either because the sector is declining and the process has to be managed for political reasons, or because, like agriculture and the Common Agricultural Policy, strong political lobbies in certain key countries have successfully demanded support. Unfortunately, for some Associated States their trade in sensitive areas could amount to half their total trade with the EU, giving these exceptions considerable practical importance. Ironically, too, once certain transition economies join the EU they are likely to find that their domestic production in these areas comes under very strong influence from the Commission: thus old-style central planning will eventually give way to centralised planning from Brussels!

The liberalisation of exports from the Associated States to the EU was also subject to quite complex local content rules, usually specifying that over 60 per cent of the market value of exports must comprise either locally produced inputs or inputs purchased from the EU. Initially, there was no provision in the definition for imported materials purchased from another Associated State but this foolishly restrictive condition is no longer in place. Since 1997, diagonal cumulation of rules of origin has applied across the Associated States, the EU and the European Economic Area (Mayhew, 1998, pp. 67–71).

Nevertheless, until this recent agreement about rules of origin, it was not unreasonable to view the system of Association Agreements as a hub (EU) and spoke (each Associated State) structure with no requirement for liberal trade policies to be in place between the Associated States themselves (see Baldwin, 1994; and Figure 1). To some degree this position was offset by the existence of the Central Europe Free Trade Agreement (CEFTA), providing for substantially free trade between Poland, the Czech Republic, Hungary, Slovenia and Slovakia. However, inefficient tariff structures in Romania and elsewhere have often made it more profitable to trade with the EU rather than with a near neighbour. In this way, the structure of Association Agreements has not yet fostered economic integration across Central and Eastern Europe itself.

Though not confined to trade in goods and services, it is convenient to remark briefly here on moves towards EU enlargement from the standpoint of the impact of the process on the trade policy of transition economies. The current position, following the EU's assessments of 10 applicant states in terms of their ability to fulfil the three Copenhagen criteria for accession (political democracy, adoption of the EU's *acquis communautaire*, and the ability to withstand normal market competition within the EU) is as follows. First, the *Agenda 2000* papers published by the Commission in mid-1997 proposed that entry negotiations should be opened initially with five transition economies, namely Estonia, Poland, Czech Republic, Hungary and Slovenia. This approach was confirmed at the EU's

FIGURE 1
Hub and Spoke Structure



Luxembourg summit in December 1997 and negotiations commenced in Spring 1998. More recently, it has been confirmed that similar discussions can be opened with other applicant states, though clearly no state will be admitted until it is deemed to be ‘ready.’ Negotiations, not surprisingly, are both highly technical and extremely prolonged, so it is unlikely that any new states will actually be admitted into the EU before 2003. Earlier entry could only come about if the EU suddenly mustered sufficient political will to accelerate the process. At the time of writing, this appears unlikely, though the EU’s most recent assessment of the applicant states, published in mid-November 2000 (European Commission, 2000), envisages that negotiations for the more advanced ones could be completed by the end of 2002. (On enlargement, see House of Lords, 1997; Grabbe and Hughes, 1998; Ambrus-Lakatos and Schaffer, 1996; and Curzon Price et al., 1999.)

Once admission occurs, there will be some important implications for trade policy in the states concerned. First, they will implement the EU's Common External Tariff and this will imply that any local free trade agreements with countries that do not belong to the EU will be superseded (possibly after an adjustment period). For instance, this could affect Estonia since that country has agreements with Latvia, Lithuania and Ukraine. The CEFTA countries might not be so affected if they all succeed in entering the EU at about the same time. Second, for some products subject to tight regulation within the EU, such as agricultural produce, imports from outside the EU will become more expensive (due to the EU's tariff regime) and countries will need to buy what they need from EU sources. Third, some countries are already concerned to learn what production quotas they will receive from the EU in agriculture and other sensitive products, since this will essentially determine their trading opportunities in these key sectors.

Perhaps fortunately, the detailed study of Baldwin, Francois and Portes (1997), based on a multi-country CGE model, showed that all the countries involved with the EU enlargement process would benefit from it (in terms of higher levels and faster growth of GDP). Existing member states, especially the larger ones like Germany, would experience relatively small, though still positive benefits, while the acceding states would enjoy large benefits due to their improved access to the large EU market, and the associated gains from greater economies of scale and economic specialisation made possibly thereby. Although the enlargement process is slow, this estimated configuration of benefits at least makes it likely that eventually, the requisite political conditions will be mobilised to complete it.

(b) The CIS: Customs Unions and links with the EU: An early study of the impending break-up of the Soviet Union and its possible economic consequences was Havrylyshyn and Williams (1991) which drew attention to the pervasive trade controls in the region, especially on exports, and the likely disruption of trade that would follow the establishment of separate currencies by each new country. The disintegration of the Soviet Union certainly presented the newly emerging countries with a dilemma as regards their foreign trade policies, namely: (a) Should they seek to preserve as much as possible of the trade flows in the region that existed before 1991? (Note, of course, that before 1991 this was not international trade, but internal trade of the Soviet Union, so not subject to tariffs, customs controls or other regulations, though it was subject to the controls on commodity flows that formed part of the central planning mechanism operated by Gosplan and Gossnab.) Or (b) Should they ignore the past, liberalise trade without regard to the established commodity flows, and then undertake the necessary industrial restructuring?

The three Baltic States effectively chose option (b), redirected their trade towards the West, and quickly sought new forms of economic integration in that direction. This is why these three states were included in the previous sub-section. The 12 CIS States, on the other hand, initially failed to make any clear choice at all, quickly observed that trade amongst them collapsed dramatically in 1992 and 1993 (see the next section), and only then tried to rescue the situation. As Michalopoulos and Tarr (1997) explain, they established a Free Trade Area (FTA) as the culmination of a series of mostly unsuccessful policies to bring about a recovery of trade amongst CIS members. In a Free Trade Area, the member countries generally agree not to impose tariffs or other forms of trade restriction on trade between each other, but each member is free to operate whatever trade policy it wishes with third parties. Accordingly, the CIS FTA entailed zero tariffs on imports from one CIS country to another, but there was no attempt to set an agreed external tariff for the whole area. In practice, however, trade was often limited by lack of foreign exchange, institutional weaknesses in the areas of banking, credit, insurance, etc., and the export controls still maintained by some countries.

In 1995, Belarus, the Russian Federation and Kazakhstan agreed to form a Customs Union (CU), which the Kyrgyz Republic joined in 1996. Conceptually, a CU is the same as an FTA with the additional feature of an agreed Common External Tariff (CET), in this case to be applied only to trade with non-members of the CIS. For this particular CU, the Russian tariff was taken as the basis for the CET though none of the members has yet implemented the CET in full, the Kyrgyz Republic has continued to operate its uniform 10 per cent tariff on all imports, and both Belarus and Kazakhstan have suspended the CET for certain product groups where they considered it to be disadvantageous for them.

For these countries, given the legacy of Soviet technology and the many factories often located highly inappropriately across the region, both the FTA and the CU are likely to prove economically disadvantageous for several reasons. First, there is likely to be a predominance of inefficient trade diversion rather than beneficial trade creation as a result of these policies. Second, the countries concerned are, in effect, proposing to provide each other with incentives to go on using out-dated Soviet-era technology by making it more costly to access Western technology. Third, given the problems most CIS countries are experiencing in raising revenues to finance public spending, it is not necessarily wise to pursue trade policies that could actually entail a loss of revenues. Last, unlike the EU or NAFTA, trade agreements across the CIS are unlikely to form areas economically large enough or competitive enough to gain significant benefits from economies of scale and specialisation within the region.

In relation to the EU, the trading environment has relaxed a great deal since 1991, though the EU still maintains quotas against some CIS exports. Nevertheless, all CIS countries except Tajikistan and Turkmenistan now have Trade and Partnership Agreements with the EU which provide for regular political dialogue, support for democratisation, co-operation in various cultural, educational and scientific fields, support for institutional reforms, and a relatively liberal trading environment. Financially, the reform process in the CIS countries, notably in key areas of market development and institution building is supported by the EU's TACIS aid programme, as well as by funding from the World Bank, USAID and other international organisations and bilateral donors. Over the period 1990–95, the EU (including both the TACIS programme and bilateral aid from Member States) became the largest donor of assistance to the CIS.

Finally, in the wake of Russia's August 1998 financial market and foreign exchange crisis, several countries in the CIS have re-introduced some trade controls (mostly temporarily, though that remains to be seen). For instance, Russia re-introduced export tariffs on oil, gas, petrochemicals, metals and a few other goods, and Kazakhstan introduced an import ban on some Russian products and set unusually high tariffs of 200 per cent on the import of such goods from Uzbekistan and Kyrgyzstan. Thus far, Uzbekistan has reacted by introducing corresponding tariffs of its own, while Kyrgyzstan has not retaliated.

(c) WTO membership: Even in 1990, several former communist countries, such as Poland, Hungary and Romania, were already members of the General Agreement on Tariffs and Trade (GATT). Most transition economies lodged applications either with GATT, or with its successor, the World Trade Organisation (WTO), established in 1995 following the successful completion of the Uruguay Round of multilateral trade negotiations. By July 1999, the transition economies shown in Table 1 were respectively members or applicants for membership of the WTO (I do not include China and Vietnam as transition economies, though both are applicants; or the former East Germany, which automatically became a member on its union with the Federal Republic of Germany in 1990).

Most transition economies have seen membership of the WTO as an important element underpinning the reform process. For membership not only ensures that

TABLE 1
WTO Membership of Transition Economies

Members
Bulgaria, Czech Republic, Estonia (awaiting formal ratification), Hungary, Kyrgyz Republic, Latvia, Mongolia, Poland, Romania, Slovak Republic, Slovenia
Applicants
Albania, Armenia, Azerbaijan, Belarus, Croatia, FYR Macedonia, Georgia, Kazakhstan, Lithuania, Moldova, Russian Federation, Ukraine, Uzbekistan

Note:
Transition economies not listed above include: Bosnia and Herzegovina, Tajikistan, Turkmenistan, Yugoslavia (i.e. the federation of Serbia and Montenegro).
Source: *WTO Annual Report 1999.*

trade with other WTO members will be carried out according to agreed rules that promote economic efficiency, but it provides for a disputes mechanism in case of difficulties between member states. For transition economies in particular, membership of the WTO usually entails agreement to many measures that have to do with the country's domestic policies. For instance, most subsidies to domestic firms in tradable sectors (whether state-owned or private) would contravene WTO principles since they could unfairly influence international trade. Likewise, the WTO has rules on the treatment of VAT – based on the destination principle (exports are relieved of VAT, imports are subject to VAT at the rate of the importing country) – which ensure fair treatment as between domestic and foreign production in any given market. This is problematic for several CIS countries which, in their trade with each other still operate according to the origin principle (VAT levied at the rate of the exporting country), while applying the destination principle in most of their trade outside the CIS. In many cases, however, WTO rules concerning both trade practices and domestic policies can provide governments with a useful tool to help them resist domestic pressures for special protection. (For fuller discussion of WTO accession for transition economies, see Michalopoulos, 1998; on issues facing Russia in particular, see Broadman, 1999.)

The process of becoming a WTO member can be rather prolonged, depending both on the determination of the applicant state, its readiness to implement the policies associated with WTO accession, and on the complexity of the issues raised by existing WTO members in the course of the negotiations. For instance, in the case of the Russian Federation, the country first applied to join GATT in late 1993, and submitted its detailed memorandum on the foreign trade system in 1994, with extensive question and answer interchanges between the Russian Government and either the GATT/WTO Secretariat or WTO member states over the subsequent two years. After 1996, the whole issue fell into abeyance, partly due to Russia's doubtful willingness to undertake the reforms considered necessary by the WTO, especially where these concerned domestic economic policies, and partly due to the tough demands placed on Russia by trade partners, for instance in terms of access to the Russian market for financial institutions and other service providers. At present, with a new President and a new Russian government in place, it is likely that the negotiations will be resumed and accelerated. Other transition countries, such as Bulgaria, have become WTO members after a 2–3 year process of negotiation. It would be difficult for a country to meet all the conditions for accession much more rapidly than this.

(ii) Policies of partner countries

Not only did the transition economies themselves greatly liberalise their trade policies, but in important respects their principal trade partners did so too (aside from that already discussed in connection with the systems of Association Agreements and Trade and Partnership Agreements), albeit with some hesitation.

Specifically, before 1990 Western countries imposed strict controls over the export of high technology products to the socialist bloc. These controls were administered by a committee linked to NATO, the Co-ordinating Committee on Multilateral Export Controls (or COCOM), whose provisions were often embodied in the domestic legislation of NATO member states, e.g. in various Export Administration Acts in the United States. With the ending of the Warsaw Pact, the rationale for such controls rapidly disappeared, though it took until 1993 for all these controls to be lifted and COCOM discontinued. It is worth noting here that even while it was in effect, the justification for COCOM in terms of the West's strategic interests was not very convincing, since it stimulated industrial espionage, reverse engineering and local production in some very important technologies. Increasingly, moreover, these technologies not only had military or defence-related applications, but they became important in civilian production (and later, consumption), too (see Hanson, 1988; Rode and Jacobsen, 1985; and Ishaq, 1999).

Being centrally planned, with most production in public ownership, and with a state monopoly over foreign trade administered through networks of foreign trading enterprises, the socialist countries were designated by the developed market economies as 'state trading countries'. This categorisation, linked to assumptions about the irrationality of prices under socialism, was used to justify the imposition of trade restrictions by the developed countries. Thus the US, the EU, and some individual member states of the EU set export quotas against many products, especially exports from the then Soviet Union. The state trading designation was also used, in conformity with GATT and later the WTO rules, to bring anti-dumping cases against socialist countries using procedures that could not be used against a market economy. For instance, judgements about dumping could be made with reference to the costs and prices of a suitable (supposedly comparable) market economy country, rather than to those of the accused socialist country, since its own prices (and hence, costs) were deemed to be irrational.

Once the transition to the market was under way, one might have expected that the designation of state trading would quickly disappear. However, although this was the case for many countries in the region, US trade policy towards Russia remains subject to annual renewal and comes with some political strings to do with the freedom of emigration of Jews from the country. In relation to other countries, US policy has gradually moved away from the practices associated with the state trading model towards more normal trade. However, there remain some market access issues where the US and other countries still maintain quotas on exports of certain products from some or all of the transition economies. In their WTO negotiations (see above), several transition economies have sought to have these quotas lifted in exchange for their offers of market opening and access in connection with WTO accession.

b. Foreign Exchange Market Liberalisation and the Exchange Rate

With the exception of a small number of barter-type deals, most foreign trade transactions are settled by monetary payment in an acceptable convertible currency (most often, for the transition economies, the USD or the DM), and hence involve the foreign exchange market. Necessarily, therefore, foreign trade policy and policy as regards the foreign exchange market are closely linked. Since it is not our main focus in this paper, however, our examination of that market will be very brief. Three aspects call for attention: (a) the exchange rate regime; (b) the extent of current account convertibility; and (c) the extent of capital account liberalisation. These three aspects of foreign exchange market policy are inter-connected both with each other, and with domestic monetary policy (e.g. policy on interest rates). The exchange rate in particular, notably its tendency towards real appreciation in some countries, can also impact on export competitiveness (see Rosati, 1996). Table 2 summarises the status of foreign exchange market policy in all transition economies as of 1998/1999.

Starting with the *exchange rate regime*, it can be seen the different countries have made different choices, sometimes, as in Bulgaria's case, following a severe financial crisis. All the main regimes that can be found in the macroeconomic literature are present among the transition economies: fixed rate; floating rate; managed float; crawling peg; and currency board. As Drabek and Brada (1998) emphasise, neither the theoretical nor the empirical work on exchange rate regimes has been able to provide an unambiguous ranking of regimes. Countries typically choose a regime as part of their macroeconomic stabilisation policy, the exchange rate serving as a nominal anchor. But as Drabek and Brada (1998) observe, if fiscal policy or other policies are inappropriate, the determination to protect a chosen exchange rate or regime can result in enormous pressure to introduce protectionist trade policies. Hence although usually unintended, there can be some quite difficult interactions between exchange rate and trade policy. These interactions are important partly because they can encourage countries to introduce inefficient trade restrictions in circumstances when the real problem lies elsewhere (e.g. in poor fiscal policy); and partly because whatever the trade policy in force, trade expansion is fostered by policy stability rather than by frequent twists and turns.

On *current account convertibility* it can be seen that most transition economies have achieved full current account convertibility, a performance that contrasts markedly with the much slower moves to convertibility by OECD countries after the Second World War, and even slower progress by most developing countries. This raises the question whether it was sensible for the former communist countries to move so rapidly to current account convertibility. Such convertibility

TABLE 2
Foreign Exchange Regimes in Transition Economies, 1998/99

Country	*Exchange Rate Regime*	*Current Account Convertibility*	*Capital Account Liberalisation*
Eastern Europe			
Albania	managed float	full	
Bosnia and H.	currency board (set at KM 1 = DM 1)	full	
Bulgaria	currency board (with 1000 leva = DM 1)	full	
Croatia	managed float	full	
Czech Republic	managed float	full	partial
FYROM	fixed (30.9 denar = DM 1)	full	
Hungary	crawling peg with band (currency basket 70% DM, 30% USD, band ∀2.25%)	full	yes
Poland	crawling peg with band (currency basket of DM and USD, band ∀15%, crawl rate 0.3% per month)	full	yes; limited controls on short term flows
Romania	floating	full	yes for inflows, partial for out-flows
Slovak Republic	floating	full	
Slovenia	managed float	full	yes; limited controls on short term flows

means that economic agents have unimpeded access to the exchange market to buy and sell domestic currency to facilitate imports and exports, and to transfer earnings (profits, dividends and the like). To be effective, it implies that there are administrative mechanisms in place, and the competence to operate them, to distinguish between current and capital transactions and to maintain controls over the latter. Some countries where such an administrative capacity is lacking might consider it worthwhile to retain more general exchange controls in order to constrain unwanted capital flows.

Cooper (1997) considers the issue of current account convertibility and finds that although the evidence is mixed, those countries in transition that moved fastest to achieve convertibility have performed better economically than those that pursued more restrictive policies. Thus there is no indication that moving rapidly towards convertibility is disadvantageous. This suggests that Western European countries could well have achieved convertibility sooner than they did and implies that many foreign exchange controls still operated by various countries might not be justified (except, perhaps, for the point at the end of the previous paragraph).

Finally, a few remarks on *capital account liberalisation*. Thus far this mostly applies only to those countries that are well on track towards EU accession and

TABLE 2 (Continued)

Country	*Exchange Rate Regime*	*Current Account Convertibility*	*Capital Account Liberalisation*
Baltic States			
Estonia	currency board (set at 8 kroon = DM 1)	full	
Latvia	fixed (set at LVL 0.7997 = SDR 1)	full	
Lithuania	currency board	full	
CIS			
Armenia	managed float	full	
Azerbaijan	managed float	full	
Belarus	multiple exchange rates; managed float	limited	firms periodically required to deposit hard currency earnings with the state
Georgia	floating	full	
Kazakhstan	managed float	full	
Kyrgyzstan	managed float	full	yes (all foreign exchange controls abolished)
Moldova	floating	full	
Russian Federation	managed float	full	liberalisation partly reversed after 1998 crisis; firms periodically required to deposit hard currency earnings with the state
Tajikistan	managed float	full	
Turkmenistan	fixed	limited	
Ukraine	managed float	full	
Uzbekistan	multiple exchange rates; managed float	limited	

Sources: *Transition Report*, London: EBRD, various issues.

which have already joined the OECD, since these organisations both expect commitments concerning capital market liberalisation. Of the new OECD member countries the Czech Republic has made the least progress towards freeing up the capital account. All the transition economies permit capital inflows in the form of foreign direct investment (see below), though sometimes this is still subject to licensing and other forms of administrative control, especially in the CIS. Policy towards capital outflows is normally far more restrictive though in practice strict policy is frequently circumvented by weak or corrupt administration, and a lack of political will to make controls really effective. In some countries, such as Russia, ineffectively applied policies and a generally unstable policy environment have permitted huge capital outflows (capital flight), offsetting much of the benefit of the capital inflows – both foreign direct investment and aid – that have come into the country. In any case, for Russia in particular, foreign direct investment has been at very low levels, not much more than USD 100 per capita over the decade 1988–98. Estonia, the Czech Republic and Hungary have all attracted over 10 times as much FDI in per capita terms, over the same period (see Table 3 and the discussion below).

c. Foreign Direct Investment

By the beginning of transition, scarcely any foreign direct investment (FDI) had gone into the (former) socialist countries, largely due to legal restrictions, the unfavourable business climate, complex licensing and other procedures, and the risks associated with the political environment of the time. Once serious, market-oriented reforms were under way it was expected that the transition economies would enjoy an upsurge in FDI and that this would significantly contribute towards their restructuring by bringing in not only new money, but also management skills, marketing expertise including access to new markets, financial

TABLE 3
Foreign Direct Investment in Transition Economies, 1990–1998

	FDI Inflows ($ million)			*Cumulative Inflow (1988–1998)*	
Country	*1995*	*1997*	*1998*	*$ million*	*$ per capita*
Eastern Europe	9152	9116	13155	53162	481
Albania	70	48	36	374	120
Bulgaria	90	505	141	1092	131
Croatia	81	388	854	2102	469
Czech Republic	2562	1300	1617	10383	1010
Hungary	4453	2085	1935	17397	1720
Poland	1134	3077	6326	14922	385
Romania	419	1215	1598	4040	180
Slovakia	157	161	401	1438	267
Slovenia	176	321	165	1271	638
FYROM	9	16	83	143	71
Baltic States	457	1142	1828	4929	653
Estonia	205	267	485	1550	1085
Latvia	180	521	286	1671	689
Lithuania	73	355	1057	1708	462
European CIS	2363	7128	2939	19751	93
Belarus	15	192	118	423	41
Moldova	64	72	69	274	63
Russian Fed.	2017	6241	1977	16311	111
Ukraine	267	623	775	2742	54
TOTAL	11972	17386	17922	77842	235

Sources: *Economic Survey of Europe in 1996–1997*, Geneva: UNECE (from Table 3.6.16), *Economic Survey of Europe in 1999*, Part 1, Geneva: UNECE (from Table 3.7.4).

expertise, and access to new technology. Though much FDI did indeed come into the region, it was not on the expected or desired scale for many countries and was initially highly concentrated in just a few countries, most notably Hungary (especially in terms of the indicator, cumulative FDI per capita), as Table 3 shows.

In the early 1990s it was not too difficult to understand why FDI flows, and hence the accumulated stocks of FDI in different countries, should have turned out to be so concentrated. Some countries, such as Hungary, were quick to adopt favourable policies towards FDI while also pursuing general reforms with considerable vigour. Hungary also, unlike most other countries, adopted a mode of privatisation that strongly favoured the sale of enterprises rather than some form of free distribution of assets, and this, too, provided opportunities for FDI especially in the mid-1990s when the pace of privatisation reached its peak. In much of Central Europe, an obvious attraction for investors was the resulting access to the EU market resulting from the network of Association Agreements, an attraction strengthened as the EU moved towards an enlargement that would take in several transition economies as full members of the Union.

Many countries were much less welcoming, or placed explicit barriers in the way of FDI, or simply failed to develop a favourable business climate in general, with particularly damaging effects on FDI inflows. Ukraine and Russia are two important countries that fall into this category. In both countries, weaknesses in the systems of legal protection for investors and excessive political involvement in FDI policy must have deterred substantial investment, despite the existence of many potentially profitable opportunities. In Russia, a further complication was the multi-level structure of government, often leaving investors unsure whether they needed permission from the *oblast'* or region where they wanted to invest, or from the central government, or from both – and in the latter case it often proved difficult to get the different levels of government to agree on terms and conditions for any given project. Not only in Russia, but in several other countries, political instability (including involvement in civil wars or international warfare) discouraged FDI, for obvious reasons.

Another factor that exerted a major impact on investors for a time was the way in which different countries dealt with their external debts. At first, of course, these were debts that had accumulated under socialism and some countries suggested that they should simply be written off to enable them to start their transition to the market with a clean slate. Not surprisingly, this approach gained little support from the international community. Moreover, in the early years of transition several countries pursued policies which, although not usually intended to have such an effect, nevertheless resulted in rapid increases in their external debt. By the early 1990s several countries of the region were formally in default. Hungary stands out as a country that has a high level of debt (in relation to its GDP, and in relation to its export earnings) and which, as a matter of policy, has consistently fully serviced its international obligations. While sometimes criticised for its rectitude, since the policy has not been without its costs and empirical evidence suggests that defaulters are not necessarily excluded for long from world capital markets (see Eichengreen and Portes, 1989), Hungary's approach was perceived as credible and therefore encouraged FDI inflows as investors could feel reasonably secure. Poland, in contrast, was in default already in the late 1980s and was unable to reach agreement with the Paris and London Clubs regarding debt relief and the re-scheduling of payments until the mid-1990s. By then the Polish economy was already growing rapidly and was increasingly viewed as a promising location for FDI.

In the former Soviet Union, the Russian Federation assumed the external debts of the Union (and also claimed all the external assets of the Union, such as embassies and the like) and, during the 1990s, sought debt relief and re-scheduling, as well as substantial aid. Given the enormous and readily exportable volumes of natural resources available from Russia, reflecting the country's huge natural wealth, surprising amounts of aid were forthcoming (from the IMF, World Bank, EU, EU Member States, etc.). Moreover, this was during a period in which the country's political and economic instability, and extensive corruption and mis-management, led to enormous capital flight, probably in excess of USD 10 billion per year in the latter 1990s (see OECD, 2000; and IMF, 1999). Investors could hardly be expected to feel safe in such conditions.

For investors themselves, different forms of FDI were available, from greenfield investment in a wholly new business to purchasing a share in an existing business, e.g. in the course of privatisation. Such investments can have diverse motives, from establishing a new market position (especially in the early stages of transition), access to skilled labour or (sometimes) particular technology and expertise, or access to cheap labour. Whatever the motive, most foreign investments bring to the recipient country new management methods and work practices, new technology, training, and new market linkages. In terms of wider impact on the host country, some investments stimulate general improvements in the policy environment that then provide more favourable conditions for subsequent investors. Some investments displace domestic suppliers from the local supply chain, replacing their inputs with imports, e.g. from the parent company; others, through their demanding quality requirements, exert a strongly positive effect on the development of local suppliers (for interesting case studies and related analysis, see Estrin, Hughes and Todd, 1997).

3. DIRECTION, COMPOSITION AND SCALE OF TRADE

a. Overview of Major Trends

Having discussed in some detail various dimensions of trade policy in the transition economies, we now present a brief overview of trade flows and trade balances for these economies since 1989 or 1991, basing the discussion on data reported in successive issues of the *Transition Report* (London: EBRD, various years).

Referring first to Eastern Europe and the Baltics, there are broadly two types of trade experience over the past decade. First, there are the countries whose exports and imports have grown very rapidly during the 1990s, often by a factor of three or more. This group includes the three Baltic States, Poland, Hungary, the Czech Republic, the Slovak Republic, Slovenia and possibly Romania (from 1990). With the exception of Romania and in some respects the Slovak Republic, these are countries which have undertaken rapid and determined reforms in most of the areas needed for building a market-type economy. Trade liberalisation, an increasingly Western orientation in trade (except, perhaps, for Lithuania) and rapid restructuring have fuelled a process which is now generating good growth performance in this group of countries. The more successful countries in this group (starting with Poland) have already surpassed their 1990 GDP levels, following the initial post-communist recession.

Second, there are countries especially hard hit by the break-up of the CMEA or intra-Soviet Union trade links, or beset by civil war and/or domestic economic crises (sometimes of their own making). For this group, which includes Albania, Bosnia and Herzegovina, FYROM (Former Yugoslav Republic of Macedonia), as well as Bulgaria and Croatia, trade showed at best modest growth during the 1990s and in some cases was lower at the end of the period than it had been at the start. There has been some economic growth in these countries but it has mostly been neither rapid nor steady. In some countries there has been substantial real decline, with GDP and living standards still well below the levels achieved around 1990. For the most part, reforms in these countries have been pursued with much less vigour than in the first group (partly for unavoidable political reasons), with results that are plain to see.

Next, let us turn to trade of the CIS member states, where the picture is totally different. For these countries, the main ‘economic fact’ is that the post-communist decline in production and GDP continued unabated for some years, only levelling off in the mid- to late 1990s and only in a few cases giving way to renewed growth. This general situation has been worsened in some countries by civil and international war (e.g. in the Caucasus and in Central Asia), and sometimes ameliorated by the retention of central controls over the economy (e.g. Belarus). This is not to say that such controls are normally to be recommended, but in a highly unstable economic and political environment, fraught with conflict, they can occasionally be helpful. Against this background, it is perhaps not surprising to find that not a single CIS country has exhibited the trade growth of Hungary or Poland. With the exception of Belarus, most CIS countries saw only modest increases in their trade flows during the 1990s, following an initial dramatic collapse. In Moldova, exports actually fell a little further during the

1990s while in Turkmenistan the collapse in exports continued to be catastrophic. For most CIS states, the share of exports going outside the transition economies changed very little or increased, but in a few cases – notably Belarus, Tajikistan and Turkmenistan – the share of exports to non-transition economies fell quite markedly. Thus despite a general move towards more liberal trade policies as described above, the CIS region has not succeeded in becoming noticeably more integrated into the world economy since 1990 (unlike Eastern Europe and the Baltics), and its share of world trade continued to fall.

For the whole region, although demand factors are not irrelevant, supply-side factors to do with product quality, institutional deficiencies in areas like export credits, trade insurance and banking services, and information about economic conditions and distribution costs in various markets are still extremely important for export success. These issues are studied for eight smaller transition economies in Cooper and Gács (1997), but the same phenomena are almost certainly more severe in the CIS, especially as one moves East.

b. The Future: Convergence and Equilibrium

What can economic theory tell us about the likely volume and direction of trade of the transition economies? If we refer to formal theories of comparative advantage, and the more recent theories of intra-industry trade in imperfectly competitive sectors enjoying economies of scale, the answer is probably ‘not a lot’. For these theories generally help us to construct good stories to explain the patterns of trade we actually observe, but they have not proved very powerful in terms of forecasting what these patterns will be, largely because the comparative advantage that drives trade flows is itself a very dynamic phenomenon, influenced in a variety of ways both by economic forces and explicit policy choices. For transition economies, however, both the direction and structure of trade were heavily distorted by the constraints of central planning and the socialist state-trading institutional arrangements. This makes it more likely than usual that relatively simple forecasting or modelling exercises might enable us to project some of the major changes in the direction and structure of trade that can be expected.

Accordingly, to assess the likely changes associated with transition, we start by examining macroeconomic approaches such as gravity models, then examine some analyses of competitiveness. These are supplemented by a discussion of the impact of economic policy on trade flows.

(i) Gravity models and related approaches

For some transition economies, especially those in Central Europe, a very simple way of predicting future trade flows and patterns is based on a historical approach. Specifically, one can examine the inter-war trade patterns of Hungary, Czechoslovakia, Poland, etc., and use these data – suitably scaled up – to make projections about the likely evolution of trade during transition. This approach was employed quite successfully by Collins and Rodrik (1991), and turned out to give sound predictions for the Central European states for which good, inter-war trade data were available. In particular, the method highlights the shift from an Eastern to a predominantly Western orientation in trade, and also correctly foresees an increase in trade volumes. For the former Soviet Union the method is not really applicable since it would be necessary to go back to before the First World War to find a reasonably ‘normal’ period as a basis for comparison (and even that period was marked by substantial state intervention into the economy), but the political configuration of the region was greatly different from the present day’s and the available data are at best fragmentary.

A more general approach to predicting trade flows is based on the so-called gravity model. By analogy with the Newtonian theory of gravitation, this predicts that the trade flow, T_{12}, between two economic entities (usually countries, though the model can also be applied to trade between regions/districts within a country) is proportional to their respective economic ‘masses’ (usually measured by their GDPs, thus Y_1 and Y_2) and inversely proportional to the economic ‘distance’ between them, d (usually measured as distance between capital cities, though for geographically large countries like the US and Russia this might not be wholly satisfactory). This gives, in simplest form, the model:

$$T_{12} = A.(Y_1.Y_2)/d^k,$$

where A and k are constants to be estimated. In practice, this model is usually linearised by taking logarithms of each side, and generalised to allow for powers of Y other than unity and alternative measures of distance, but the essence is as stated here.

Applying this approach to a dataset of 76 countries (19 developed industrial and 57 LDCs), Hamilton and Winters (1992) estimated the parameters in a gravity model of trade flows. They then extended it to selected transition economies by inserting data on the relevant GDP levels and economic distances in order to project the expected trade flows in Central and Eastern Europe. Their calculations showed that only a small proportion of Central Europe’s trade would be conducted with the former Soviet Union, that Germany would be the leading trade partner for much of the region, and that over half of Central Europe’s trade would be conducted with the EU. Overall trade would grow considerably, which would entail significant adjustment by Western countries to allow more extensive access for imports from the transition economies.

These approaches are essentially macroeconomic in nature, in that they reveal the likely volumes of trade between different pairs or groups of countries, without indicating which products are likely to be exported, and which imported. For a few countries, such as Russia, the main exporting sectors are linked to resource endowments, hence exports of oil, gas, metals and minerals, forestry and timber products. For most of the region, however, both exports and imports depend on competitiveness, to which we now turn.

(ii) Competitiveness

At the start of transition, given the hitherto prevailing price distortions and trade restrictions, it was unclear which sectors or products were likely to be competitive in world markets, and which would not. This was potentially of importance for policy at the time since judgements about likely future competitiveness could have influenced the willingness of governments to offer temporary subsidies to selected enterprises to facilitate essential restructuring. Enterprises that were uncompetitive should either be scaling down their operations and preparing for market exit, or undertaking sufficient investment to make them competitive reasonably quickly – thus several countries in Central Europe have seen uncompetitive parts of their food processing sectors transformed by FDI. The most inefficient approach, though widely pursued for political reasons, is to subsidise persistently loss-making enterprises for long periods without demanding serious restructuring and modernisation. The common problem for governments or the banks was (and to some degree still is) to identify – and so support – those enterprises which do have a future following restructuring, and to encourage the scaling down and eventual closure of those which have no chance of viability in the post-communist world.

An early approach to measuring competitiveness was developed in Hughes and Hare (1992 and 1994), based on the calculation for several countries of domestic resource costs (DRCs) and social rates of profit by sector. These estimations involved recalculating the profitability of production by (tradeable) sector using world market prices as achieved in the given country's export markets. The results were extremely interesting, showing that each country possessed sectors with negative DRCs (implying negative value added at world market prices) and other sectors with highly competitive DRCs. Energy intensive sectors like cement were often uncompetitive (presumably a consequence of the long-term under-pricing of energy, and the inappropriate location of the firms concerned), as was much of the region's food processing industry. It should be noted here that a 'normal' country facing few constraints on trade and enjoying an economic system with relatively few distortions would not, in any case, have such a wide dispersion of DRCs across its industries. So the findings for transition economies gave a clue as to the extent of necessary restructuring (though subject, as always, to cautious interpretation, due to the poor quality of some of the data used in this research).

Subsequent studies of competitiveness and structural change employed alternative approaches. Thus Neven (1995) and Halpern (1995) used different economic indicators to assess competitiveness. Neven reports on import penetration in Central and Eastern Europe by broad sector, and calculates revealed comparative advantage by sector (RCA, measured as $\{x/X - m/M\}$), finding that the Eastern countries are likely to be relatively competitive in sectors intensive in capital and unskilled labour. The study also finds evidence that on-going restructuring is giving rise to changes in comparative advantage, making prediction of future patterns increasingly difficult. Halpern looks at the evolving trade patterns and seeks to assess how far they reflect comparative advantage. He proceeds by examining a range of domestic indicators of unit labour costs, educational and R&D levels, confirming the general impression that the region is endowed with a rather skilled, well educated labour force (relative to its achieved level of economic development). However, without huge investment the region could be stuck with outdated technology and more labour-intensive production. Hence FDI has a potentially major role in bringing about rapid transformation in the region's leading competitive sectors, especially as continued reliance on labour-intensive production and exports (e.g. through outward processing operations) is vulnerable to wage increases that could quickly drive such activities elsewhere.

Landesmann (1995) projects the process of East-West economic integration forward to 2010 by associating each transition economy with a weighted sum of market economies, either recent entrants to the EU or on its borders, which closely approximate the employment structure of the given transition economy. The key hypothesis is that by 2010 all the transition economies – both in Central and Eastern Europe and in the former Soviet Union – will have reached the levels of trade performance currently achieved by their respective comparator countries. On this basis, the region as a whole is likely to see its share of EU imports rise from only 2 per cent in 1987 to 8.5 per cent in 2010, a fourfold increase in market share. Hungary's share of the EU market is expected to rise sevenfold. Six sectors – mostly natural resource based – are likely to see especially large rises in their long-run EU import shares, namely paper, chemicals, mechanical engineering, metal products, mineral extraction, mineral products, while another six sectors are expected to perform relatively poorly: instrument engineering, office equipment, leather, motor vehicles, transport equipment, other goods.

Myant (1999) takes a rather pessimistic view of the prospects for long-term growth and improving competitiveness of the Central European countries in particular. Although conceding that basic, market-oriented reforms are in place, the author suggests that these reforms have not (yet) stimulated sufficient development of more advanced activities, and that more active government policies – plus massive investment – are needed to achieve this. I am unconvinced that such pessimism is warranted and other studies, such as OECD (1998), find evidence of improving quality and competitiveness at least in some sectors. This study examined both inter-industry trade, to which standard conceptions of competitiveness most readily apply, and intra-industry trade (for an empirical study of intra-industry trade between East and West Europe, see Aturupane et al., 1997). Increases in the share of intra-industry trade in Eastern Europe's total trade with the EU were interpreted as evidence of quality improvements in the transition economies. Likewise, the EBRD's *Transition Report 1997* (p. 68) found some interesting evidence of quality improvements in Central European exports to the EU, though none in Russian exports (at least, none in the selected sectors).

(iii) The role of policy in bringing about changed trade direction and structure

The economic forces sketched above clearly go a considerable way towards explaining the observed changes in the direction and structure of foreign trade by the former socialist countries, especially when they are supplemented by two further important factors: (a) the initial, post-communist decline in aggregate output, especially marked and persistent across the CIS, and still only imperfectly understood; and (b) the trade imbalances that emerged from the break-up of the Soviet Union, which forced several CIS member states to cut imports sharply in order to avoid the excessive accumulation of new foreign debts. Unfortunately, this sort of unco-ordinated response probably contributed to the general decline in output as a whole.

The economic policies described in the previous section, however, exerted several effects, some positive, some negative. First, and most obviously, the general liberalisation of trade allowed the economic forces just discussed to operate with relatively little hindrance in much of the region. Second, those countries that also operated sound domestic policies and quickly provided a stable and positive environment for investment, including FDI, benefited from early and quite large FDI inflows that contributed greatly to economic restructuring in certain key sectors. Third, some countries which liberalised trade too quickly and too completely subsequently backtracked a little, either for revenue reasons (tariffs are often easier to collect than other taxes, especially if the tariff schedule is not too complex), for reasons of temporary domestic protection to give firms time to adjust and restructure, or in connection with trade negotiations (to give a bargaining counter, to preserve future flexibility). Thus Poland raised tariffs in 1992 having previously reduced them to very low levels, and Estonia, while not formally raising tariffs, bound its tariffs at higher than the prevailing levels in its WTO accession negotiations in order to retain flexibility. Several CIS countries have adopted a similar approach.

Fourth, for balance of payments reasons a few countries in the region have applied temporary import surcharges (e.g. Hungary), but they have usually done so within WTO rules and have lifted the surcharge within agreed periods. Some countries have been concerned about an allegedly over-valued exchange rate discouraging exports, though on the whole not much use has been made of devaluation as a formal instrument of trade policy. Notable exceptions to this picture have been Russia in 1998, which devalued sharply after the August financial crisis, and Hungary in 1995, which devalued as part of a stringent financial package introduced to check persistent balance of trade deficits, as well as unsustainable deficits in the public sector accounts (see Halpern and Wyplosz, 1998). Mostly, though, it seems to have been well enough understood that currency devaluation alone might only offer temporary benefits, soon lost through accelerated inflation. Conversely, as discussed above, many countries have used a form of exchange rate peg as an anchor to assist in restraining domestic inflation.

Fifth, we come to the question of controls over capital flows, a difficult and controversial area as was indicated above. Relaxing such controls too soon in the transition process, or managing them poorly through the banking system, before domestic stabilisation has been achieved, and before favourable conditions for domestic business development are securely in place, is clearly dangerous and can be destabilising. The real difficulty is this area is how to design and implement policies that are truly credible and sustainable, given limitations of administrative capacity and political will. Even achieving full current account liberalisation pre-supposes that there is sufficient administrative expertise to distinguish properly between capital and current account transactions so that the former can still be controlled. Credibility might sometimes mean retaining more official controls than might otherwise be desirable.

Last, it is important to mention a number of countries whose trade policies, though liberalised in important respects, continue to be subject to various forms of mostly inefficient distortion. Important countries like Russia and Ukraine come to mind here. The former still has some high taxes on exports of energy products (notably oil and gas; see OECD, 2000) and maintains a rather differentiated import tariff schedule with rates mostly in the range 8–30 per cent, with an average tariff rate of around 15 per cent. Such differentiation can result in high rates of effective protection for some sectors, though in the Russian case the observed pattern of tariff rates does not appear to have any such obvious (even if inefficient) rationale. It does, however, artificially protect some sectors from external competition. In principle this is not necessarily objectionable provided that the period of protection is being used to enforce substantial real restructuring. But since Russia's domestic policies also often provide protection and inhibit restructuring, it is not easy to feel much confidence about that. Likewise for Ukraine, trade protection and domestic policies combine to inhibit restructuring in key sectors that are currently highly inefficient in international terms (see Åslund and de Ménil, 2000).

4. CONCLUSIONS AND LESSONS

a. Rapid Liberalisation

A number of important conclusions can be drawn from the above account of trade policy and practice in the transition economies during the 1990s. Perhaps the most significant one is the simple observation that early views regarding the desirability and sufficiency of rapid trade liberalisation proved to be hopelessly inadequate for several reasons.

First, while it is generally accepted that a liberal trading environment characterised by low, and preferably fairly uniform, tariffs and minimal non-tariff trade barriers is conducive to economic efficiency, it does not follow that moving to such a state overnight is appropriate. Sudden liberalisation can impose a huge adverse shock on domestic enterprises, giving them no time to adjust before external competitive forces sweep them away. The most striking instance of this phenomenon was the case of East Germany, following the re-unification of the country in 1990, though the situation there was clearly exacerbated by the politically motivated but economically disastrous exchange rate at which unification took place. Other countries have also suffered from over-rapid liberalisation, which has sometimes been reversed for a time to give more time for domestic adjustment.

Second, successful trading in world markets requires substantial institutional support of the sort that was mostly lacking in the transition economies when the communist system was abandoned. This includes the existence of adequate banking services able to deal in convertible currencies; export credit guarantees; trade insurance; export promotion services to help overcome informational deficiencies to do with operating in foreign markets; efficient and honest customs services; etc. For some transition economies, especially those in Central Europe, bringing these services up to a reasonable standard was accomplished rather rapidly, but in much of the CIS such business-related services still function very poorly and significantly impede trade. Even in Central Europe, though, Frensch (2000) argues that the extent of restructuring from manufacturing and agriculture into services has limited the extent to which improved export performance could serve as the spur to renewed, rapid economic growth.

Third, trade policy and certain aspects of a country's domestic policy cannot sensibly be treated as separate issues. Some countries, for example, have liberalised trade while continuing to protect inefficient domestic firms for local political reasons. Such policies are bad for the budget since they combine revenue losses (from tariff reforms) with additional spending on subsidies; they also delay restructuring and discourage the formation of new businesses, and hence keep the countries concerned uncompetitive. It is fair to ask why such policies have been pursued if they are so damaging. The reason has to do with the political economy of policy-making, rather than with the economics *per se*. Strong, domestic political constituencies have been able to demand continuing subsidies to large established firms without necessarily imposing significant conditions regarding restructuring. The mode of privatisation – largely to insiders – in a country such as Russia has facilitated these tendencies by leaving intact the networks of support linked to the larger enterprises.

Fourth, a further reason for the insufficiency of domestic liberalisation is that free trade for the transition economies also entailed major changes in the policies of trade partners, notably the EU, the US and other developed countries. As we have seen, the EU gradually developed either Association Agreements or Trade and Partnership Agreements with most transition economies, and most export restrictions against transition countries were lifted by the early 1990s. The only remaining difficult areas are the so-called 'sensitive products', agriculture and food products, steel and steel products, textiles, and a few others, though these cover a significant fraction of the relevant trade flows.

b. Free Trade Areas and Related Policies

The second striking feature of the 1990s trade policy of the transition economies has been the tendency to form wider economic groupings. These include CEFTA in Central Europe, the CIS free trade area, and the customs union involving Russia, Kazakhstan, Belarus and Kyrgyzstan. It was suggested above that the last two were unlikely to be economically very desirable as they would tend to lock in the countries concerned to outdated, Soviet-era technology. In contrast, the enlargement of the EU, expected to bring in up to 10 transition economies as new member states of the EU (with five on track for relatively early entry) is a process expected to bring substantial economic benefits to all concerned. The process is not, however, without its political difficulties, especially as such a large-scale enlargement calls for significant reforms of the EU's internal decision-making mechanisms and a reorientation of the EU budget towards the East, all of which are proving highly controversial and difficult to implement.

c. Exchange Rates, Current Account and the Capital Account

In several respects, policies towards the foreign exchange market influence foreign trade. Most countries have already established more or less full current account convertibility which, among other things, implies that all agents involved in the conduct of foreign trade, whether as importers or exporters, enjoy unimpeded access to either foreign exchange or the domestic currency market, as required. The establishment of convertibility also implies that other current transactions are no longer subject to controls, but except in the few countries with significant liberalisation of capital flows, the latter remain subject to restrictions. How effective these can be is another matter, since the maintenance of controls over some transactions and not others pre-supposes an ability: (a) to classify transactions properly; and (b) having done so, to set up suitable administrative machinery to operate controls over the restricted categories of transaction. For many countries, including some transition economies, these requirements cannot be fulfilled. In such cases, it might be better to keep in place more comprehensive controls over the foreign exchange market in preference to relinquishing all effective control over the market.

d. Reorientation of Trade

As expected from analyses based on the gravity model and other approaches, most transition economies would naturally tend to conduct the bulk of their trade with the West, far less than formerly with their erstwhile socialist partner countries. The statistical evidence bears out this expectation, though there is still some way to go in terms of trade volumes (i.e. a great deal of further growth can be anticipated) and a long way to go as regards the restructuring and modernisation of production and hence exports. For Central Europe, there is already substantial evidence that export quality is improving in many product groups and the increasing share of intra-industry trade can also be taken as an indicator of more advanced trade. For the CIS the picture is far less satisfactory, with little evidence of improving quality of manufactured exports and, for some countries, increasing shares of trade still being conducted with the former socialist partners.

e. An Ideal Trade Policy

Finally, we draw out from the above analysis the features of an ideal trade policy for the transition economies, taking account of the diverse circumstances of the different countries and hence the need for some differentiation of policies between them. The key to a successful trade policy is to tailor reforms to the political and administrative capabilities, and institutional infrastructure, of each country. In the worst case, where these are weak and undeveloped, the only effective trade policy is one that is administratively simple and relatively immune to political manipulation and corruption. Considerations of theoretical economic efficiency might well be secondary factors in the design of policy in such a situation. Table 4 presents in summary form some suggestions about the appropriate trade policy for a number of alternative scenarios.

Some of the suggested approaches to trade policy reform fit in with the analysis of optimal reform sequencing, a topic explored in Roland (2000, esp. ch. 2). Roland argues – both on theoretical grounds, and from a study of the reform

TABLE 4
Trade Policy in the Transition Economies: Alternative Scenarios

		Politics/Administrative Capability	
		Strong	*Weak*
Economic reforms	*Advanced*	Liberalise trade; tariffs can be uniform or differentiated; current account liberalisation; capital account liberalisation also fine. Good conditions for FDI. No special need to protect domestic firms and in any case, the incentives provided by trade policy reinforce those implicit in domestic policy.	Potentially dangerous situation since the reforms could be quite fragile, subject to political manipulation, or subject to failure as a result of corruption and other administrative weaknesses. Hence it is most important to build state capacity, as compared to which arguments over details of trade policy are not very fruitful. However, it can help if the trade policy in place is simple and relatively safe against corruption.
	Medium; weak financial institutions (incl. banks)	Complete financial market and banking reforms, undertake trade liberalisation.	Essential to build up state capacity, both politically and administratively, while completing reforms.
	Early stages	Undertake domestic reforms rapidly, incl. trade liberalisation.	Important to find ways of enhancing state administrative capacity and enabling the state to function better. In the meantime, essential to design trade policy to reduce risks of capture by interest groups and to limit opportunities for corruption. Hence go for uniform tariffs (so no incentive to misclassify goods), maintain controls over foreign exchange market, esp. capital account. Need for caution over FDI initially.

experience of transition economies, that helpful first steps are the development of a small-scale private sector (as a basis for functioning markets), the introduction of competition policy laws, and institutional reforms – both economic and political. He also points out that privatisation should generally proceed by privatising the best firms first, on the grounds that this helps to build support for later stages of reform. Conversely, closure of major loss-making firms tends to be delayed until less controversial and politically difficult reforms have been accomplished. These desiderata explain why, with a weak state in the early stages of reform (bottom right cell of Table 4), I focus on administrative and political reforms to strengthen capability, and propose a very simple and transparent trade policy. Such foundations can then be built on later once the policy environment gains in credibility. Corresponding observations can be made about the other cells of Table 4.

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